

Converting to a Cooperative

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Below is an overview of the process to convert a conventional business to a cooperative. For more in-depth information, read our [Legal Guide to Cooperative Conversions](#).

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Benefits of Cooperative Conversion

Converting non-cooperative businesses to cooperatives is an empowering decision for workers and consumers, and a realistic and sound business choice. For many reasons, cooperatization may be an attractive option for consumers, workers, current owners, and the communities in which the enterprise is embedded.

Converting to a cooperative is good for the **enterprise**. Cooperatization can...

- Maximize innovation through collaborative teams of high-impact individuals
- Attract, retain, and reward talented individuals by distributing risk while offering direct participation in governance and surplus
- Generate wide community buy-in, thus increasing the longevity of the enterprise
- From the Ohio Employee Ownership Center: "The General Accounting Office's ... found that the combination of employee ownership and employee participation yielded substantial improvements in firm performance ... Numerous research studies ... indicate [a] direct and positive correlation between high levels of employee participation ... and increased performance and production."

Converting to a cooperative is good for the **existing owner**. Cooperatization can...

- Streamline an owners' exit and maximize privacy of the transaction.
- Help an exiting owner rest easy knowing her/his venture is being stewarded by experienced, competent, invested individuals.
- Enable the existing owner to sell at a control premium
- Let the existing owner take advantage of the 1042 Rollover (to shelter their capital gains from taxation)
- Let the existing owner continue working for the business and receive internal capital allocations annually or just remain more passively involved as a debt or equity financier.

Converting to a cooperatives is good for the **community** within and around the enterprise. Cooperatization can...

- Distribute risk and maximize institutional and community independence
- Satisfy unmet social, economic needs and correct market failures
- Provide true community ownership, buffering communities from impact of outsourcing and market centralization

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- Generate, circulate, and retain community wealth

If the current owner(s) decides to pursue cooperative conversion, here are some of **the steps** they will need to undertake. (Note: the following is not intended as a “how-to” or a flowchart—once the transaction is in full gear, several of the steps outlined below will occur nearly simultaneously.)

Steps to Cooperatize

Assembly of a Cooperative Steering Committee

Those interested in becoming the owners of the new cooperatives should assemble a cooperative steering committee. In some instances, the current owner(s) (especially when a cooperative is being used as an exit strategy) will approach prospective member-owners. In other instances, prospective member-owners will convene a steering committee independently, and will then approach the owner with their desire to convert the business to a cooperative. In either of these instances, cooperative development firms and organizations may support or facilitate the process. It will be a good idea for the Cooperative Steering Committee to develop a vision or mission statement, processes for decision-making, processes for joining the Steering Committee, and expectations for those participating on the Committee.

Owners’ Assent

Control of traditional capitalist businesses is in the hands of the owners. Though the impetus to cooperatize may or may not come from the owners, ultimately, the owner(s) needs to agree to the process of cooperatization, i.e. to sell the business to the new member-owners, or to sell some of the business’s assets to users (workers, consumers, or producers) seeking to create a cooperative. In some cases, owners will be excited at the prospect of conversion. In other cases, it could take years of negotiation. A recalcitrant owner certainly can refuse to permit the cooperatization of the business, and can certainly refuse to sell its assets to a cooperative comprised of its former employees. It *cannot*, however, stop its employees from leaving the business to create a new cooperative business for themselves.

Appraisal of Existing Business and Advising

The Steering Committee should engage professional advisors, such as cooperative developers, lawyers, and accountants, to investigate the feasibility of a cooperative conversion, the financial health of the business, and its actual and potential liabilities. At this stage, it is smart to reach out to cooperative financing organizations like [The Working World](#) and [cooperative development organizations](#), and bring them on as key partners. Some pieces of this step will require the cooperation of the selling owner, particularly where confidential information is required. The Committee should also obtain an independent appraisal of the value of the company.

Arrangement of Financing

The next three steps will likely be undertaken simultaneously rather than linearly. In order to purchase the business, prospective member-owners will likely need to use a variety of financial sources, and structure the transaction as a leveraged buy-out. A leveraged buy-out is a transaction that is financed by a combination of equity (ownership stake) and borrowed money (debt that will have to be repaid) and in which the cash flows and physical capital of the company are used as collateral for the borrowed money.

The first and, in some ways, most important source of capital for the transaction is the equity shares which will be purchased by the new cooperative member-owners. The Steering Committee will need to decide whether there will be one or multiple classes of shares and how much an ownership share will cost (if ownership shares will be expensive, it will also need to consider how the individual purchase of shares can be financed). The Steering Committee will also need to decide whether it wants a class of “preferred shareholders” – that is, a class of investors who contribute a sum of money beyond the standard share cost and, in exchange, get a fixed regular dividend with no (or very limited) governance rights attached. Grants may also be available for cooperative development.

Prospective member-owners will likely also need to explore debt financing. The lender(s) can be a commercial financial institution, a private investor, a community development financial institution (CDFI), or the selling owner. It is important to note that it is difficult to convince any lender, especially a conventional commercial lender, to debt-finance 100% of a transaction. Lenders are reluctant to do this even for common transactions (like mortgages) and are even more reluctant to do this for more “exotic” transactions (like a cooperative buy-out). Thus, the Steering Committee may find that it is impossible to purchase the business in one transaction. In that case, it could consider the possibility of completing the sale through multi-stage (or multi transaction) co-op purchase as [Select Machine](#) did. In this sale structure, the worker-owners secure a loan (which conceivably could come from the initial owner herself)

to finance the first transaction. Once the worker-owners pay down that loan, they secure another to buy another portion of the business. This continues until the worker-owners own 100% of the stock/assets. In order for the owner to take advantage of the 1042 Rollover, at least 30% of the business must be transferred in the initial transaction. In the years following the transaction, the cooperative will need to dedicate its profits towards repaying the loan that financed the transaction, whether that loan came from a financial institution or an individual. This will reduce the cooperative's net income available for distribution as patronage dividends. In a multi-step sale, the cooperative should execute the steps in the plan outlined in the buy-out agreement in order to eventually purchase 100% of the business.

In multi-stage cooperative buy-outs, the selling owner plays a critical financing role. She is supporting the health of the business (and thus success of the conversion) by keeping her equity stake in the business, and may be providing collateral for loans taken out by the cooperative to purchase the business, or providing the loan itself. This is a vulnerable position for an owner to be in. There are mechanisms by which to protect the owner's stake. Assurances can be included in the sale agreements (Offering Statement, Stock Purchase Agreement, etc.) that the cooperative will act so as to protect the owner's remaining ownership interests. Safeguards can also be built into the governance documents, such as supermajority voting requirements for decisions affecting the owner's proprietary interests, and other reserved rights to withhold consent for major corporate changes until all of the Owner's stock has been redeemed.

Amendment of existing entity OR creation of a new entity

Depending on how the existing entity is organized, the Steering Committee may be able to simply adjust the existing entity's key documents, or it may have to create a new entity that then purchases the existing business/business assets. Cooperative statutes vary widely from state to state; some are very modern and adaptable, and others are more archaic. If you are exploring cooperatizing in a state with a more archaic statute, you may consider organizing as a [non-cooperative cooperative](#) and then tailoring your operating agreement/bylaws to meet your cooperative goals. For a discussion of the different cooperative entity options, check out [this Co-opLaw.org page](#). Note that many states permit only those businesses incorporated under cooperative statutes to use the word "cooperative" in their legal name.

Is the business a sole proprietorship?

If the existing entity is a sole proprietorship, it may make the most sense to incorporate/organize a new cooperative entity, as sole proprietorships do not feature limited liability.

Is the business a partnership?

If the existing entity is a partnership, it may make the most sense to incorporate/organize a new cooperative entity, as partnerships generally do not feature limited liability. First, ensure that you meet the sale conditions in the Partnership Agreement. There are often restrictions on selling partnerships interests.

Is the business an LLC?

If the existing entity is an LLC, it may be possible to remain an LLC and simply add new "members." The operating agreement would need to be amended to create a cooperative structure through provisions regarding membership, democratic governance, profit-sharing, etc. LLC members (i.e. owners) are not generally considered employees, and thus a cooperative formed as an LLC may have more flexibility with respect to employment requirements like minimum wage, payroll tax deductions, overtime, workers' compensation insurance, issuance of W-2s, etc. Sometimes this flexibility is valuable for small or start-up cooperatives that want to rely more heavily on "sweat equity" for a time. LLCs are "pass-through entities" meaning that taxes are not levied at the entity level – LLC profits are distributed to members, and members then pay taxes on them. In this way, LLCs avoid the "double taxation" that corporations are sometimes subject to. For more on taxation of cooperatives, see [Patronage Accounting and Tax Basics](#). However, it may make sense to organize a new cooperative entity (a legal cooperative or a non-cooperative corporation) that then purchases the LLC. While the flexibility of an LLC can be a boon, it also means that it would be relatively easy for future membership to demutualize the business.

Is the business a corporation?

If the existing entity is a corporation, it may make the most sense for the converters to simply amend the business's key founding and governance documents (articles of incorporation and bylaws) to become a "[cooperative corporation](#)."¹ Even if your state does not offer a cooperative corporation statute, a corporation's articles and bylaws can probably be amended to meet your cooperative goals (by adding

provisions regarding membership, democratic governance, distribution of profits, and, if relevant, protections for existing shareholders). The articles and bylaws should also be made to comport with the requirements of Subchapter T (the IRS designation for cooperatives) as well as the relevant state cooperative law. The enables the cooperative to avoid some of the traditional corporate “double-tax.” Assuming the cooperative meets all the requirements set forth in the Code, patronage dividends are generally tax-deductible for the cooperative if at least 20% of each patronage dividend is paid out in cash. For more on taxation of cooperatives, see [Patronage Accounting and Tax Basics](#).

It is also possible to create a separate employee cooperative that would buy part or all of the stock and exist as a separate holding company to hold the target company’s stock for the benefit of its employee-members.¹ This entity would, for all intensive purposes, be an employee leasing company with one client. This option may be attractive to the initial owner, because if the existing entity is converted to a cooperative (the process described above), democratic authority immediately vests in all worker-owners, even if the initial owner’s stock is not yet fully redeemed. By contrast, in the employee leasing scheme, the owner would not be required to relinquish control until 100% of the stock has been redeemed. The downside is that this structure is clunky. The original company would, in effect, need to purchase the labor of the leasing company employee members so that the leasing company would have an appropriate revenue stream from which it could allocate patronage refunds to the employee members. Mere stock ownership would not provide such income.

An important nuance to appreciate is the difference between ownership of a company, and ownership of a company assets. Where workers are seeking merely to purchase the assets of their employer company, as was the case with [New Era Windows](#), workers can form a separate entity that then purchases the target company’s assets (provided the owner is willing to sell them). This is generally a far narrower, and thus more straight-forward transaction.

Sales Agreement between buyer(s) and seller(s)

Generally, a sales agreement will need to be negotiated and signed by the initial owners and the new cooperative entity. The agreement should include the sale price, the list of assets being transferred, and the terms of the transfer. Look for sample buy-sell agreements to learn more about what typically goes into such an agreement, and consult with a lawyer to make sure that important terms are not omitted.

Where the Seller is a Corporation, and the Buyer is a Cooperative Corporation, the sale may occur through a Stock Redemption Agreement³

The parties should prepare a [Stock Redemption Agreement](#). If the current owners wish to take advantage of the 1042 Rollover, and if the transaction is happening in multiple stages (as demonstrated by the [Select Machine](#) case study), the Stock Redemption Agreement should provide for the sale of at least 30% of the selling owner’s shares. This Stock Redemption Agreement should set out the share price, a control premium, if any (remember, the selling owner can extract a premium at step one, because control of the board will immediately pass to the cooperative members), and the relevant representations and warranties. The stock redemption agreement will also include assurances to the owner that the cooperative will act to protect the owner’s remaining ownership interests, describe how the owner will support the employees’ financing of the stock purchase, and outline future steps to complete the cooperative’s purchase of the owner’s stock.

The owners’ attorney should probably simultaneously prepare an [Offering Statement](#), which is a general written disclosure to the selling owners and the prospective worker-owners of all the relevant risks associated with the transaction. The Offering Statement will outline the risks of selling shares and transferring control; the risks of employee investment in the company; the terms of the Stock Redemption Agreement; and the securities and tax law issues surrounding the transaction and the continuing operation of the business. It will also describe the company’s reorganization into a worker cooperative, including attaching the new articles and bylaws (spelling out the terms and conditions of membership), as well as its business planning and finances. The purpose of the Offering Statement is to make a fair disclosure to potential members of the risks and responsibilities of becoming a worker-owner; it also provides lenders with a clearer understanding of the transaction. It is not a Securities and Exchange Commission disclosure statement. Worker buy-outs are *generally* an excluded securities offering under Section 4(2) of the Securities Act of 1933 (which governs registration of sales of securities).

Assignment of Appropriate Tax Status.

Subchapter T Status: During the reorganization or sale of the existing entity, the Steering Committee should take care to ensure that the Operating Agreement or bylaws comport with Subchapter T of the Internal Revenue Code, if Subchapter T tax status is desired. Subchapter T is the law that governs the taxation of cooperatives. Selecting taxation under Subchapter T will enable the partial pass-through taxation characteristic of cooperatives.

1042 Election: If the existing business is a corporation, once the initial sale of shares to the cooperative is executed, the selling owners should elect to have their capital gains income from that sale taxed under Section 1042. As mentioned below, if the owners reinvest their sale proceeds within one year, taxes on those capital gains will be deferred. If the existing business is a sole proprietorship, partnership, or LLC, there is precedent for the IRS permitting conversion to a corporation before cooperatization in order to take advantage of the 1042 Rollover.

Adjusting Management

The converted cooperative will continue its business operations, albeit with a new board, new governance structure, and new system of distributing profits. The selling owners can continue as members of the cooperative, provided they meet all the conditions of membership (such as working for the cooperative full-time).

The 1042 Rollover, ESOPs, and Worker Cooperatives

Often, when people discuss “employee ownership,” they are talking about employee stock ownership plans, or ESOPs. An ESOP is a type of employee benefit plan. In an ESOP, a company sets up a trust fund, into which it contributes new shares of its own stock. Shares in the trust are then allocated to individual employee accounts. Although there are some exceptions, generally all full-time employees over 21 participate in the plan. As employees accumulate seniority with the company, they acquire an increasing right to the shares in their account. This process is called “vesting.” When an employee leaves the company, she receives her stock, which the company must then buy back from her at its fair market value.

A special provision of the Internal Revenue Code, introduced in 1984, provides business owners with an incentive to create ESOPs. Section 1042 allows owners of closely-held corporations (a closely held corporation is a corporation with a small number of controlling shareholders) who sell at least 30% of more of their stock to their employees to shelter their capital gains from taxation if they roll over the sale proceeds into other qualified domestic securities within 12 months of the sale. Historically, business owners have taken advantage of the “1042 rollover” by creating ESOPs, but the IRC also extends the incentive to owners who sell their business to “eligible worker-owned cooperative.”

Though the 1042 Rollover applies equally to ESOPs and worker-owned cooperatives, these two options are quite different. For example...

- There are differences in decision-making power and structure. An ESOP is a trust that is managed by a trustee, whereas a worker cooperative is directly owned by the workers. Because an ESOP is only indirectly and partially owned by workers, the cultural shift required to make an ESOP successful is far less dramatic than that required for a worker cooperative.
- There are also regulatory differences. ESOPs are an employee benefit plan and are regulated by the Employee Retirement Income Security Act of 1974 (ERISA). Worker cooperatives are not regulated by ERISA.
- Cooperatization can happen in a company with far fewer employees than the minimum required to create an ESOP (25).
- The goal with an ESOP is still to maximize shareholder value, whereas the goal of a cooperative is to benefit the members.
- A subchapter T cooperative is not a tax exempt entity, whereas an ESOP is tax-exempt. An employee cooperative is much less expensive to establish and maintain than an ESOP, but it has fewer immediate tax advantages beyond the IRC §1042 deferral of recognition with respect to gains from the Owner's sale of stock.

Case Studies: Businesses That Have Made the Conversion

Select Machine: Keeping it in the Family

Select Machine is an Ohio-based firm that manufactures, sells, and distributes custom parts for demolition and construction equipment. It was founded in 1994 by Doug Beavers and Bill Sagaser. When Beavers and Sagaser began considering retirement in 2006, the company had 11 employees and sales of \$2.5 million in 2006.⁴ Neither owner had a family member who wanted to assume ownership of the company, so Beavers and Sagaser began seeking out buyers. Several offers materialized, but all prospective buyers were

primarily interested in getting hands on Select Machine's client list. Beyond that, they would shut down the plant and cherry-pick through the equipment for use at underutilized facilities elsewhere. This spelled out layoffs for Select Machine's current employees. Beavers and Sagaser considered the employees of Select Machine – which is located in a rural, close-knit community – to be family. They did not want to see the plant shuttered and their friends out of work. "These are our guys, our family, and we wanted them to keep on working," Sagaser says.⁵

In 2005, Beavers' and Sagaser's banker suggested they contact the Ohio Employee Ownership Center (OEOC) for guidance. OEOC director, John Logue, knew that an Employee Stock Ownership Plan (ESOP), a standard exit strategy incorporating features of employee ownership, would be too expensive for a small operation like Select Machine.⁶ [See above for details on the different between ESOPs and worker cooperatives.](#) Logue suggested that instead, Select Machine explore conversion to a worker co-op as an exit strategy. Though the 1042 Rollover had not been utilized in the conversion of a business to a worker co-op, the IRC authorized such a practice.

The OEOC staff conducted several meetings with the owners, reviewed the company's financials, and toured the facility to get a better understanding of the business and to start charting out what the transaction would entail.⁷ Beavers and Sagaser discussed the idea of converting to a worker-owned business to the employees, and were met with enthusiasm. OEOC then met with the employees to explain the basics of worker cooperatives and how such a conversion could be structured for Select Machine. The employees then voted to investigate the possibility of setting up a co-op, and elected a "buyout committee" to undertake that task. A preliminary feasibility assessment of an employee purchase was funded Ohio Department of Job & Family Services' Prefeasibility Study Grant Program, and was performed by Brott Mardis, a local accounting firm, and included a valuation.

At the completion of the feasibility study, Mark Stewart prepared an offering statement for the employees.⁸ The prospective worker-owners then took time to review the offering statement, the feasibility study and valuation, and the financial statements of the company. The employees then held a vote on whether to set up an employee-owned cooperative – they ayes had it. They then moved into deliberations about how to structure the cooperative, qualifications for membership, membership fees, and how to allocate patronage. They set the co-op membership fee at \$1000. They developed a weighted patronage formula to use for allocating profits amongst the worker-owners. The formula assigns 50% to W-2 earnings (rewarding current market value of their skills), 25% to hours worked (rewarding diligence and equality), and 25% to seniority capped at 120 months (long-term contribution to the business). Until the debt is paid off, the worker-owners' patronage allocations will go to pay down the note used to acquire their stock.

To finance the deal, Logue and attorney Mark Stewart developed a multi-stage buy-out plan wherein the cooperative initially took out \$324,000 in loans from a local bank and revolving loan fund, all personally guaranteed by Beavers and Sagaser, to finance the redemption of an initial 40% of Beavers' and Sagaser's stock. (This initial redemption had to be of at least 30% of Beavers' and Sagaser's stock in order for them to take advantage of the 1042 Rollover.) The monthly loan payment of \$6,000 would come out of the company's cash flow.⁶ Once the loans were repaid, Beavers and Sagaser would sell the remaining shares to the cooperative. They then would retire from the business. In the intervening period, they would train the other co-op worker-owners to run the business successfully.

Beavers and Sagaser became members of the co-op as well. To do so, they each put up a portion of their unredeemed stock holdings as their membership stock (their portions being equivalent to the average membership stock the other members hold). Whereas the patronage allocations distributed to the other worker-owners goes to paying down the debt used to purchase the worker-owners' stock, Beavers' and Sagaser's patronage allocations go directly into their capital accounts. After all, their membership stock is not debt-financed – as it came from their unredeemed stock holdings, they already own it. To be clear, however, while Beavers and Sagaser will build their capital accounts within the co-op, they will not acquire additional stock in the process. Additionally, the Beavers, Sagaser, and the cooperative executed an owners' employment agreement which provided Beavers and Sagaser with certain reserved rights as "protected shareholders" until their stock is fully redeemed.

The articles of incorporation of Select Machine were amended and restated to establish the firm as a cooperative under Ohio Cooperative Law. New bylaws that enabled cooperative governance and profit-sharing were written to replace existing company bylaws. The worker-owners elected a board of five comprised of the two selling owners and three new worker-owners. The new board then voted to authorize the redemption of 40% of Beavers' and Sagaser's stock, and to authorize the cooperative's borrowing the money to fund it. From the initial conversation between Select Machine and OEOC to completion, the deal took six months.

While the cooperative planned on purchasing the outstanding 60% of stock by 2010, the dismal economy led the workers to elect to delay on the transaction.¹⁰ Due to a decrease in revenues, the company reduced its work force on a voluntary basis in 2009. As the economy began to recover in 2010, however, Select Machine, Inc. is back up to pre-recession revenues, and the worker-owners have resumed the process to complete the full acquisition.

New Era Windows: Saving American Jobs

Chicago, Illinois

New Era Windows is a Chicago-based worker-owned cooperative that produces and installs energy efficient, soundproof windows.¹¹ Their journey to cooperatization began in 2008, when, after many decades of operation, Republic Windows and Doors, the family-owned firm by which New Era's worker-owners were then employed, abruptly shuttered its Goose Island factory and declared bankruptcy.¹² When the announcement was made, workers were told their jobs would be terminated immediately, and that they would not receive the backpay or severance to which their contracts entitled them. The workers occupied the factory in protest, a move that won them nationwide media attention, a nod from then President-Elect Barack Obama, as well as the health benefits and \$1.75 million in back wages that they demanded from Republic.¹³

Incidentally, Richard B. Gillman, Republic's owner, has since been charged with a variety of financial crimes related to the bankruptcy.¹⁴ According to the allegations in court filings made by the federal bankruptcy trustee, Gillman "hung on to the company just long enough to avoid penalties for violating a tax-increment financing agreement, in which Republic took in about \$10 million in taxpayer money to build its Goose Island factory." The case is still awaiting trial.¹⁵

In 2009, Serious Energy, a California-based green construction company, bought the Goose Island factory and pledged to re-hire all 250 workers.¹⁶ For a variety of reasons, Serious Energy's Goose Island operations never took off and no more than 75 workers were ever brought back on. In February 2012, in a strange redux, Serious Energy told workers it would be shuttering the factory immediately in order to consolidate operations. No severance would be provided. Once again, workers voted to occupy the factory.¹⁷ Initially, the workers insisted that Serious Energy keep the factory open for 90 days, to allow time for another company to buy it.¹⁸ Serious Energy agreed. But after 90 days passed with no offers to buy the factory, the workers decided to purchase the factory themselves.¹⁹

Workers reached out to the [The Working World](#), an organization that extends microcredit to worker-owned businesses, to help them organize their collective. On May 30, 2012, the workers founded New Era Windows, LLC, a worker-run cooperative that aspired to manufacture "quality, affordable windows."²⁰ Serious Energy initially agreed to delay liquidation of the plant's equipment and give New Era the first option to buy the assets. It is important to note that the workers were not seeking to cooperatize Serious Energy. Rather, they sought to purchase Serious Energy's assets through their new cooperative LLC. This distinction is explored further [above](#).

New Era's worker-owners agreed to set the worker-owner "buy-in" at \$1000, which many of them financed with the help of friends and families. In addition, it secured a line of credit from The Working World.²¹ In June 2012, New Era made its bid on Serious Energy's Goose Island equipment: \$1.2 million, with \$500,000 down (through its line of credit with The Working World).²² In early July 2012, however, Serious Energy informed New Era that the bid was insufficient. New Era and its community supporters (who included Michael Moore and Van Jones) responded with marches and petitions. In August 2012, a deal was struck between The Working World, Serious Energy, and New Era, which enabled New Era to purchase the needed equipment and rent a less expensive facility – a former Campbell's Soup plant – on Chicago's Southwest Side in which to house their operation.²³ To save money on expensive moving costs, the worker-owners themselves moved the equipment from the Goose Island plant to their new home in eighty tractor trailer loads.²⁴ The Working World ultimately invested \$665,000 to cover the purchase of Serious Energy's assets and initial rental of the new factory.²⁵ Also during this time, the Chicago-based [Center for Workplace Democracy](#), began leading classes for workers on how to run a cooperative business.¹⁸

New Era Windows officially opened for business on May 9, 2013.²⁷ Currently there are 18 worker owners, and another 20 plan to buy-in once operations get into full swing.²⁸ Eventually, the co-op hopes to have 40-80 worker owners.

Footnotes

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